

TTEP AWAITS FATE

Regulators to decide on proposed buyout Christmas week

By David Wichner

ARIZONA DAILY STAR

Unisource Energy Corp. goes before regulators Christmas week to seek final approval of a proposed \$3 billion leveraged buyout of the Tucson Electric Power Co. parent by a group of private Wall Street investors.

Whether the company gets a shiny present or a lump of coal from the Arizona Corporation Commission remains to be seen.

"I would say it's about 50-50 right now," said Maurice E. May, a utilities analyst with Westport, Mass.-based Power Insights.

Whatever the commission decides won't immediately affect utility rates, which are frozen through 2007 for 370,000 TTEP ratepayers in Southern Arizona and about 206,000 electric and gas customers of Unisource Energy Services in most of Northern Arizona and Santa Cruz County.

If the deal is approved, ownership of Unisource—one of Tucson's few locally based, publicly traded companies—would pass to a private investment partner.

Unisource deal: Trip down a sometimes bumpy road began in 2002

NOVEMBER 2003

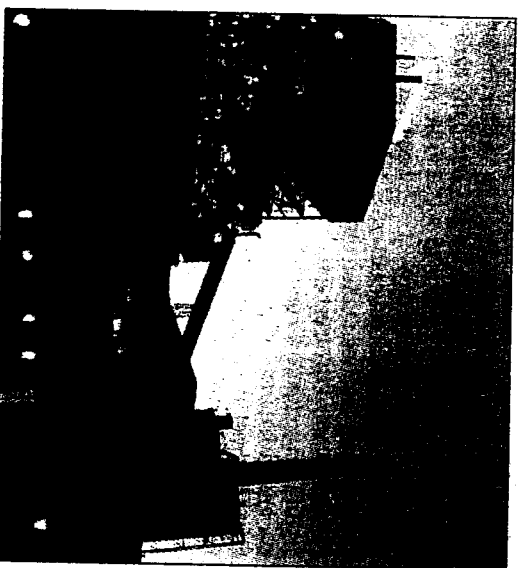
After a year of behind-the-scenes talks, an investor group led by the Wall Street firm Kohlberg Kravis Roberts & Co. agrees to acquire Unisource Energy Corp. for \$25.25 per share, in a leveraged buyout worth nearly \$3 billion in cash and debt. Unisource CEO James Pignatelli and other top management would stay at least five years.



James Pignatelli

NOVEMBER 2003

Tucson Electric Power Co. breaks ground on a new coal-fired generator at its Springerville Generating Station; the third unit is being built for a consortium of regional utilities.



Jim Davis / Arizona Daily Star 1996

The TEP plant near Springerville is the second largest photovoltaic generating site in the world.

MARCH 2004

Unisource shareholders overwhelmingly approve the buyout at a special proxy meeting in Tucson.

MAY 2004

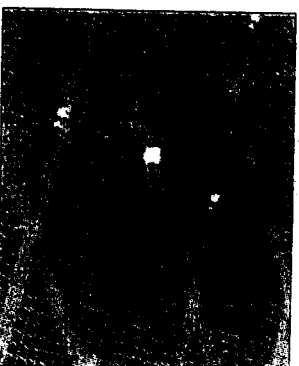
The staff of the Arizona Corporation Commission finds the buyout is not in the public interest, contending that it doesn't do enough to ensure safe, reliable utility service.

JUNE 2004

The commission staff says it is neutral on the deal after Unisource and its suitors agree to 40 new conditions designed to protect ratepayers. Weeklong hearings on the buyout are held in Tucson before a Corporation Commission administrative law judge.

AUGUST 2004

Unisource boosts TEP subsidies for installation of solar-electric panels under its SunShare program and launches a similar program for rural Arizona ratepayers of its Unisource Energy Services electric utility (acquired in 2003).



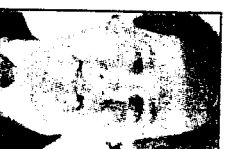
David Sanders / Arizona Daily Star
Solar panels at TEP's Springerville, Ariz., plant.

SEPTEMBER 2004

Corporation Commissioners Kris Mayes and Bill Mundell press for documents related to the investor group's expected rate of return on the buyout, citing concern that the new owners would move to raise rates or cut services to reach their profit goals.



Kris Mayes



Bill Mundell

OCTOBER 2004

The Federal Energy Regulatory Commission unanimously approves the Unisource buyout.

NOVEMBER 2004

A Corporation Commission administrative judge issues an order recommending the commission reject the buyout, citing new debt risk and lack of benefits to ratepayers.

Unisource agrees to additional conditions to protect ratepayers, offers \$10 million to conservation and low-income ratepayer programs and to boost charitable giving by \$2.5 million from 2005 to 2008.

TEP acquires a one-third interest in a partially built gas-fired power plant in New Mexico with Phelps Dodge Energy Services and PNM Resources, an Albuquerque utility.

Access to capital

Unisource contends the sale to Saginaw Utility Group, a private partnership led by Wall Street takeover specialist Kohlberg Kravis Roberts & Co., would strengthen TEP's balance

ship. Unisource's utility subsidiaries would remain regulated by the state, though Unisource no longer would be traded on the New York Stock Exchange.

If the deal falls through, Unisource could become the target of a less-tentative takeover in which the company no longer would be managed from Tucson, the company says.

David Sanders / Arizona Daily Star
Power lines along Sunset Road
are part of the TEP network.

What comes next: Final hearings on the buyout before the full
Corporation Commission are scheduled for Dec. 20-21.



TTEP

State regulators to rule on utility buyout on Dec. 20

(Continued from Page D1)

sheet by shifting debt to the parent company, giving the utility greater access to capital needed to build new power plants.

Current utility operations would stay the same, top Unisource management would remain for at least five years and Unisource's charitable giving and other community involvement would continue or increase, according to terms of the deal filed with regulators. But state regulators, consumer advocates and others worry about the long-term ramifications of the deal.

They fear the new owners would seek to boost rates or cut service in an attempt to make a

profit, while escaping some of the financial disclosure requirements publicly held companies must meet.

"Kohberg only makes investments for the greatest return on the dollar," said Kirt Jiams, a native Tucsonan and longtime TTEP customer who owns a local communications and TV production firm. "Once it's transferred, there's nothing we can do to stop them."

Regulators balk at deal

Unisource management has rallied local business support for the deal and won approval from company shareholders and the Federal Energy Regulatory Commission.

But state regulators have balked at the deal.

In early November, a Corporation Commission administrative law judge recommended the full commission turn down the buyout. Citing testimony filed during weeklong hearings in Tucson last summer, Judge Jane Rodda said the addition of

If you go

► Unisource Energy hearings

WHAT: Arizona Corporation Commission will consider a private investor group's \$3 billion buyout offer for Unisource, parent of Tucson Electric Power Co. and Unisource Energy Services.

WHEN: Dec. 20, 10 a.m. (and Dec. 21 if necessary)

WHERE: Corporation Commission Hearing Room 222, 400 West Congress St., second floor

ONLINE: Live audio Webcast at www.cc.state.az.us

up to \$660 million in debt at Unisource would pose new risk to ratepayers, with no tangible benefit in exchange.

She also cited concerns that the commission would have little control over subsequent investor or ownership changes, and that assets of TTEP — which had a brush with bankruptcy in the late 1990s after a disastrous power-plant deal and soured

non-utility ventures — might be tapped in the unlikely event Unisource files for bankruptcy.

In response, Unisource filed documents disputing Rodda's findings and agreeing to new ratepayer protections. To show a public benefit to the deal, the company offered to boost spending on energy conservation programs, including low-income ratepayer assistance, by \$10 million, and to roughly double its charitable contributions over three years with an additional, \$2.5 million, over three years.

When the five-member commission meets to decide the case Dec. 20 in Tucson, it may accept, reject or modify the administrative judge's recommendation.

Some have questions

Corporation Commission members are not allowed to comment on pending cases. But in letters filed in the case, at least three members have questioned how the prospective new owners expect to earn a profit without significantly cutting costs or boosting revenues, among other issues.

"In some ways, we don't know all the implications down the road — what if they resell the company in five years?" Commissioner Kris Mayes asked in an interview. She declined to comment on specifics of the case.

The deal looks iffy at this point, many observers say.

The credit rating agency Standard & Poor's, which put

TEP on "credit watch" pending the buyout on concerns over increased debt at the parent company, said this week in a rating update that prospects for the Unisource deal were "diminished significantly" by the "sternly worded" ACC judge's recommendation.

If the deal is rejected, Unisource would be liable to pay up to \$7 million to cover the suitor investment group's costs. Unisource CEO Jim Pignatelli said he is still "guardedly optimistic" the deal will be approved. A spokesman for KKR declined to comment on the administrative judge's decision, referring a reporter to Unisource's formal response. Pignatelli vehemently dis-

agreed with Rodda's decision, contending the deal would provide long-term benefits to ratepayers while insulating TEP from new debt risk.

"If anything, TEP is less risky with the transaction," Pignatelli said. The deal would infuse TEP with \$150 million to move a \$95 million debt to the parent company, while giving TEP new sources of credit, he said.

The company also has pledged to specifically separate the assets of the parent company and its utility subsidiary in any future loan documents, to protect the utilities from the parent company's liabilities. Those and other so-called

"ring fencing" provisions — conditions that separate utilities legally and financially from their parent corporations — have worked in the past to protect the assets of utilities, S&P analyst Anne Selting said.

Rate cut discussed

The commission may be looking for something not uncommon in utility buyouts: a rate cut, analyst May said.

In Texas Pacific Group's pending deal for Portland General Electric, a subsidiary of bankrupt Enron Corp., the private investor group has offered a \$15 million rate cut, but consumer groups say it's not enough to offset the deal's risk to ratepayers.

Pignatelli said a rate-cut offer is not in the cards for Unisource.

"I think a rate cut is inappropriate — all of our costs are considerably higher than when our rates were set," he said.

TEP rates can't go up until 2008 at the soonest, under terms of a 1999 rate settlement. Power and gas charged by Unisource Energy Services also are frozen through 2007 under terms of Unisource's acquisition of the mainly rural systems in 2003.

In a pending review of TEP's current rate freeze through 2007, the company has said its costs justify a double-digit rate increase, citing a 25 percent increase in labor costs and natural-gas costs that have more than doubled since the last rate case, Pignatelli noted.

"In the normal process, there would be give-and-takes in that — I don't want to scare anybody," he added.

Boosting energy programs and charitable giving is more appropriate and beneficial than a token, artificial rate cut, Pignatelli said.

"I felt we should give a benefit to those consumers who need it the most, not just some *de minimis* (minimal) rate decrease which would really mean 25 cents or 50 cents (a month) to the consumer," the Unisource chief said.

TEP may have to increase rates in 2008 whether the buyout goes through or not, Pignatelli said. Arizona Public Service Co., the Salt River Project and the state's electric cooperatives all have moved to raise rates recently to keep up with rising costs.

"The deal will not change what happens in 2008," he said.

A state ratepayer advocate who opposes the deal because of the added debt risk to ratepayers said he would not press for a rate cut as part of the deal.

"It isn't fair to the company and it would definitely change the dynamics of the deal," said Stephen Ahern, director of the Arizona Residential Utility Consumer Office, or RUCCO.

"You could have a rate cut today, but if the lights go out tomorrow, what have you gained?"

Seeks ways to cut costs

Sale or not, the company will continue to look for ways to cut costs without sacrificing service, quality or reliability, Pignatelli said.

For example, TEP recently increased its capital budget for 2005 by some \$10 million to buy spare transformers to allow the company to get power back up quickly in case of equipment failure, he added.

If the deal is approved, Pignatelli has agreed to stay on for at least five years, and he has vowed to invest \$5 million of his own money in the new company. He will get compensation totaling about \$11 million from the deal, for stock he's purchased and stock options earned over the years.

Pignatelli, who joined TEP in 1994 as senior vice president of business development, said he could retire next year but has no plans to walk away from Unisource if the deal is rejected.

"I would be a little frustrated for a little while, but I still have an obligation to this community and to this company and to its employees, and I wouldn't let those people down," he said.

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